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LOCAL CREDIT AND TERRITORIAL DEVELOPMENT: GENERAL ASPECTS AND THE ITALIAN EXPERIENCE

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Abstract

The purpose of this article is to explore the relationship that arose in Italy between local financial systems and local production systems in the period of the country's post-war reconstruction, when it rejoined the trajectories of modern economic development. This will be done by verifying two hypotheses. The first is of a more general nature. It states that, in a given territory, the supply of credit, and the financial system supporting it, constitute only one local factor in development. They combine with numerous other factors, even ones uncorrelated with them, which may be present in varying proportions according to the coordinates of time and place, and which give rise to the set of opportunities for investment. The second hypothesis tested concerns Italy in particular. It states that certain public choices of the post-war period, functional to specific political strategies and to more generic strategies of medium-period growth, proved unable in the long period to sustain a modern equilibrium among factor endowments, socio-cultural components, and the political-administrative apparatus. The hypotheses will be verified by considering the main findings in the theoretical and empirical literature on the general aspects of the relationship between financial systems and territorial development, and by examining the odd relationship between credit and local firms in Italy.

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I. Introduction

However paradoxical it may seem, the relationship between the credit supply and the development of a given territory is one of the aspects least explored by the economics of local development. Only recently has it attracted attention, and more from a theoretical point of view than an empirical one. One might be tempted to justify this omission with the unequivocal evidence for the relationship: credit is a necessary condition for development and therefore performs a positive function. Put in these terms, however, the question is simplistic and of scant usefulness. The fundamental issue is not whether credit is necessary; but rather what type of credit or, more specifically, what financial system – constituted by the financial markets, the institutions operating in them, and the predominant type of financial contract – best responds to the development needs of a given territory. What matters is the kinds of services which a financial system provides, as well as the efficiency with which it does so (see Cameron et al., 1967). This may depend on the extent to which the financial institutions are rooted in the territory, their ownership form, their size, their level of integration with the national financial system, the function of subsidized credit, and so on.

The paradox is apparent in the Italian case as well. Whilst on the one hand the multiregionality of development, the importance of diffused entrepreneurship and the substratum of small and micro enterprises, the weight of light industrialization, and agricultural restructuring are by now widely acknowledged and studied, on the other, relatively little attention has been paid to the territorial diversification of finance, and in particular to the function of local credit and small banks. As to be expected, the few existing studies on the matter have concentrated on industrial districts and on the period since the 1970s. Comparatively neglected have been non-district or non-industrialized areas, and above all the period between post-war reconstruction and the end of the 1960s. Generally, with few exceptions, studies on industrialization take it for granted that "the financial leverage of small firms operating in 'light' industry has pivoted substantially on their capacity for self-financing sustained by prolonged periods of growth and on the high competitiveness of flexible organization " (Conti, 1997, p. 152).

The purpose of this article is to explore the relationship that arose in Italy between local financial systems and local production systems in the period of the country's post-war reconstruction, when it rejoined the trajectories of modern economic development. Those years, in fact, saw definition of the features of the domestic political, economic and institutional context that interacted with the subsequent organizational and operational surge of small and medium-sized firms which so profoundly marked the development of large part of the Italian economy and its regions[1]. Careful examination of the period is therefore useful, if not necessary, for assessment of how the attitudes dominant in the period and the consequent decisions helped generate, through a mechanism of path dependence, some of Italy's current economic equilibria and disequilibria.

This will be done by verifying two hypotheses. The first is of a more general nature. It states that, in a given territory, the supply of credit, and the financial system supporting it, constitute only one local factor in development. They combine with numerous other factors, even ones uncorrelated with them, which may be present in varying proportions according to the coordinates of time and place, and which give rise to the set of opportunities for investment. The function of credit is to encourage pursuit of those opportunities, on the one hand by stimulating the availability of external financing for firms and reducing its cost, a function which mainly concerns more financially dependent sectors and firms[2]; and on the other, in general by engendering a selecting-out process among firms based on efficiency and innovative capacity. The presence of financial development, therefore, is not necessarily accompanied by economic development. It is consequently essential to evaluate the interactions that take place between a local financial system, on the one hand, and the level and quality of human capital, social capital, entrepreneurial function and firms' structure, on the other. In other words, it is essential to determine how a financial system interacts with the cumulative causation processes which shape the system economies of a territory.

The second hypothesis tested in what follows concerns Italy in particular. It states that certain public choices of the post-war period, functional to specific political strategies and to more generic strategies of medium-period growth, proved unable in the long period to sustain a modern equilibrium among factor endowments, socio-cultural components, and the political-administrative apparatus. Although such choices might have been justified by the conditions at the time, as their shortcomings became apparent the inability or unwillingness to correct them hampered the country's development, making broad-gauge private choices difficult, albeit leaving space for more agile and decentralized ones. This came about in particular through a distortion in the system of economic incentives due to three main factors. Firstly, there was little concern to strengthen small and medium-

[1] Explanation of Italian development during the period – strongly conditioned as it was by exports – must obviously consider the political, economic and institutional dynamics of the international context.

[2] A firm's financial dependence does not derive solely from the fact that it belongs to a sector financially dependent because, for instance, it is highly capital-intensive. It also depends on the firm's phase of development: for example, if it is young or undergoing production restructuring.

sized firms in qualitative terms. Modern legislation was not enacted to furnish a clear normative framework for contractual, social security and fiscal matters. And no measures were introduced to promote the supply of modern services dedicated to the sector, primarily banking: for instance, not only was the selective function of the financial system not enhanced, it was perverted by being substantially restricted to increasing the supply of secured credit and integrating this with subsidized credit. Secondly, the state progressively increased firms' production and transaction costs with normative rigidities, administrative sluggishness, short-sightedness, and burdensome taxation, as well as with corruption, thereby inducing firms to circumvent these obstacles with irregular behaviour. Thirdly, the state – both to facilitate the survival of the backward part of the production system and to strengthen the international competitiveness of the more advanced one (which the state weakened with its inadequacy) – was compelled to grant a series of protective and anti-competitive concessions, often giving rise to tacit collusion with the sectoral and trade-union confederations.

The hypotheses will be verified by considering the main findings in the theoretical and empirical literature on the general aspects of the relationship between financial systems and territorial development (chapter II), and by examining the odd relationship between credit and local firms in Italy (chapter III). In regard to the latter, a distinction will be drawn between the premises constituted by certain choices taken during the period between the two wars and the compromises reached between continuity and innovation of the first fifteen years of the post-war period, with the consequences of these in subsequent years, given the lack of structural reforms. Brief conclusions are drawn in chapter IV.

II. Credit and development

1. Financial system and development

The influence exerted by the financial system on development has long been a matter of controversy, and it has been examined, within broader topics, more by economic theory in general than by the economics of development in particular (see Levine, 1997), and with little or no empirical verification. On the one hand, one can identify a current of thought which has explicitly argued for its positive function, dividing nevertheless between those who have identified this function as support for capital accumulation (Bagehot, 1873, and Hicks, 1969) and those who have seen it as the selection of projects, and therefore of entrepreneurs, through the allocation of credit (Schumpeter, 1912). On the other hand, there are those who, like Joan

Robinson, 1952, have hypothesised a reverse causal connection whereby finance, like the Napoleonic *Intendance*, follows the advance of firms. Between these two extremes lie a medley of positions: ones wholly sceptical that there is any causal relationship between the two variables (Lucas, 1988); ones doubtful and suggesting the existence of a mere correlation due to the dependence of both variables on a third one, namely the propensity to save of households (Goldsmith, 1969); and more nuanced ones which maintain that the financial markets anticipate future development and that financial development is therefore only a 'leading indicator', rather than a causal factor.

It was only in the 1970s that the relationship between financial development and economic growth became an independent subject of inquiry[3] which subsequently received impetus, in both the theoretical and empirical fields, from progress in the economics of information and agency relationships and in the theory of financial intermediation[4]. In light of the latter, it was evidenced that productive activity and investment may be hindered by the existence of imperfections in credit markets: by favouring situations of adverse selection and moral hazard, information asymmetries and contractual asymmetries[5] may lead to credit rationing[6], slow development in comparison to potential, and give rise to suboptimal equilibria. The 'Modigliani-Miller theorem' – stating that how a firm is financed is irrelevant to whether or not it undertakes an investment – was thus superseded, and the financial structure of firms became central to explanation of productive choices. The task of a financial system (that is, of financial markets, institutions and instruments) is therefore to relax liquidity constraints and to mitigate the effects of information and transaction costs. More specifically, this entails the following: eliminating or reducing information asymmetries in the evaluation (screening) and control of projects and firms (monitoring)[7]; increasing the propensity to save or activating idle funds; mediating the transformation of long-term debt into less binding deposits; furnishing an implicit insurance service[8]; and facilitating the payments system. These objectives are more easily achieved

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[3] See e.g. Goldsmith, 1969, McKinnon, 1973, and Shaw, 1973.

[4] In the theoretical field see Greenwood and Jovanovich, 1990, Bencivenga and Smith, 1991, 1993, Boyd and Smith, 1992, Levine, 1992, King and Levine, 1993a. In the empirical field see World Bank, 1989, Gelb, 1988, Roubini and Sala i Martin, 1991, King and Levine, 1993a, 1993b.

[5] Contractual asymmetry derives from the nature of the contract: a bank will tend to prefer low-risk projects, with a higher expected return for the creditor, while the client will prefer riskier projects with a higher expected return for the debtor; this, also with overall expected return remaining equal, and risk-neutral contracting parties (see Stiglitz and Weiss, 1981).

[6] "If the phenomenon of credit rationing exists, it is very likely that the distribution of information is one of its causes" (Cannari e Signorini, 1997, p. 341).

[7] Diamond, 1984, defines a bank as an institution of delegated monitoring.

[8] Through emergency credit lines and interest rates smoothing.

if the financial system is able to establish continuous relationships with clients; but insider banks must be prevented from taking advantage of their greater knowledge to appropriate part of firms' profits (the hold up problem), provoking recourse to multiple lines of credit by firms.

Recent theoretical and empirical research based on international comparisons and analysis at sector and firm level therefore corroborate the existence of a meaningful relationship between financial development, on the one hand, and capital accumulation, technological change and productive improvements on the other, as summarized by the following scheme[9]:

Market frictions (information costs, transaction costs)

⇓

Financial markets and intermediaries

⇓

Financial functions

– mobilize savings (pooling)
– allocate resources (information about firms and investments)
– exert corporate control (monitoring managers)
– facilitate risk management (liquidity risk and idiosyncratic risk)
– ease trading of goods, services, and financial contracts

⇓

Channels to growth (capital accumulation, technological innovation)

⇓

Growth

Among the functions in the scheme, both the theoretical literature and the few econometric estimates performed report that the best allocation of credit among alternative projects and more careful selection of investments according to their marginal productivity (the so-called Schumpeterian channel) prevail over the push effect on capital accumulation exerted by the greater supply of liquidity (the Hicksian channel)[10]. For instance, De

[9] See Levine, 1997, p. 691.

[10] The Schumpeterian functions operate by screening entrepreneurs and certifying their quality, thereby promoting specialization and the development of entrepreneurship, as well as the adoption of new technologies. In the Hicksian functions, the intermediation of saving performed by the financial system through the diversification of risks and the reduction of transaction costs provokes an increase in the saving rate and the fraction of saving channelled into investment, directing investments to uses with greater returns. The Hicksian channel is more explicitly considered by the new neoclassical theories of growth, while the Schumpeterian channel has been evidenced by, among others, Beck, 1999, Fama, 1985, Galetovic, 1994, King and Levine, 1993c, Levine, 1999, Minsky, 1986, Moore, 1988, Stiglitz and Weiss, 1988.

Gregorio (1997, p. 70) estimates that "financial intermediation affects growth mainly by increasing the marginal productivity of capital" at a ratio of three to one[11].

It seems therefore permissible to conclude that "the development of financial markets and institutions is a critical and inextricable part of the growth process" and that adequate comprehension of long-period development is not possible until the evolution and functioning of financial systems has been understood. However, this conclusion must be drawn "hesitantly and with ample qualifications"[12], and by reprising some of the hypotheses alternative to those of Schumpeter and Hicks. Firstly, not to be neglected is the fact that the functioning of a financial system is dependent on the ongoing pattern of development and the socio-political and economic context in which it operates. We therefore have an ambivalent relationship, a mechanism of reciprocal interaction which makes it difficult to precisely identify the direction of the causal connections. Secondly, whilst one may state that financial development has a positive overall effect on economic development – despite the presence of exceptions which should be duly considered – it is also evident that 'financial development' is too generic a term[13]. Assessing this impact and the importance of these exceptions requires two linked frameworks. The first must specify the relations between the financial structure and the functioning of the financial system: that is, how different markets, institutions, and contractual forms reduce information and transaction costs and influence saving rates, investment decisions, and technological innovation - all aspects insufficiently explored for firm conclusions to be drawn. The second framework must specify the characteristics of the economic and productive system and the various relations which are established, according to these characteristics, with the financial sector: in other words, it must appraise the territorial aspects of the relationship between financial development and economic development.

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[11] Used as the indicator of the degree of financial intermediation is the ratio between credit internal to the private sector and GDP. Excluding credit to the public sector, this ratio more accurately represents the channelling of funds to the private sector: that is, the degree of financial intermediation impacting on investment and its efficacy. The indicator well captures the financial development that comes about through the banking system, but not that induced by the stock market. To be pointed out, however, is that in the early phases of development and in small firms, very little use is made of the financial market.

[12] See Levine, 1997, pp. 688-89. See also Pagano, 1993 and 2000.

[13] This may also induce errors in measurement of a financial system's functioning: "Measuring the performance of one part of the financial system [e.g. equity markets] may generate a misleading indicator of the functioning of the whole financial system" (Levine, 1997, p. 714).

2. Financial system and territory

One premise for evaluation of the territorial aspects of the relationship between economic development and financial development is that the latter does not have the same impact on all sectors and all firms, and consequently on all territories. Since markets and financial institutions reduce – through the mechanisms that we have seen – the cost of loan money, their development will have much greater repercussions on those firms and sectors which depend most on external financing: namely, new firms and sectors with greater investment commitments, more capital-intensive and/or more innovative. Scant financial development will instead favour firms already present on the market, as traditional sectors, and those with low investment intensity[14]. This possibility to expand or reduce the potential for new firms and technological and innovative sectors is an important factor "in determining the size composition of an industry as well as its concentration" (Rajan and Zingales, 1998, p. 584). And in general it is an important channel of influence on patterns of economic development at national, regional or subregional level.

A second important aspect concerns a financial structure's capacity to reduce the information and incentivation problems posed by firms for financiers, for it is on this capacity that its functionality to development depends. Since financial structures of different kinds, performing different roles, obtain different results in this regard, it is evident that, depending on the features of the economic system and its informational frictions, certain solutions will be more functional than others. In particular, as the evolutionary theory of the firm shows, the youngest and smallest firms raise the most serious problems of information asymmetry, mainly because they do not have long examinable records and/or have not yet established structured relations with the financial system. Moreover, these firms are unable to sustain the fixed costs necessary to access the financial market and the stock exchange[15]. This explains why bank credit is of particular importance not only for this type of firm but also, in general, for a territory

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[14] "Our estimates suggest that financial development has almost twice the economic effect on the growth of the number of establishment as it has on the growth of the average size of establishments". "The existence of a well-developed [financial] market … represents a source of comparative advantage for that country in industries that are more dependent on external finance. Similarly, the cost imposed by a lack of financial development will favour incumbent firms over new entrants" (Rajan and Zingales, 1998, pp. 560 and 584).

[15] "Perhaps the most important characteristics defining small business finance is informational opacity. … Small firms do not enter into contracts that are publicly visible or widely reported … do not issue traded securities … do not have audited financial statements that can be shared with any provider of outside finance. As a result, small firms often cannot credibly convey their quality … may have difficulty building reputations to signal high quality or nonexploitive behavior to overcome informational opacity" (Berger and Udell, 1998, p. 616).

or country in its early phases of development, when small firms requiring specific financial services predominate, and the financial and stock markets are neither liquid nor able to meet the demands of large part of the production system. By contrast, bank credit diminishes in importance as firm size increases and with sectoral and territorial growth.

Finally, it should be borne in mind that the existence of a developed financial system is not a sufficient condition for a given territory's development. Aside from the presence of opportunities and a propensity to invest, if financial intermediaries and banks are to become important agents of a given territory's development, they must be able to reconcile two, sometimes conflicting, exigencies: the pursuit of managerial efficiency, and the pursuit of territorial efficiency. The latter requires that banks must not settle for comfortable arrangements with firms and society, and content themselves with easy rent positions. They must not entrench themselves behind stringent equity requirements, encouraging low-risk and immediately profitable liabilities. Moreover, they must invest resources in human capital able to perform the functions of screening, contracting and monitoring; they must be able and willing to adapt flexibly to different situations; and they must assume the risk and "responsibility of supporting the local market and production activities, even during recessions and to the detriment of their own balance sheets". In short, "there is no point in having efficient banks if they do not contribute to local development" (Alessandrini, Papi e Zazzaro, 2003, pp. 30 and 27)[16].

Nevertheless, as often happens in the logic of development, at this juncture there operates a cumulative mechanism whereby the virtuous combination of the two efficiencies becomes easier to accomplish with the progress of the economy, and more difficult when situations of backwardness must be remedied. The explanation for this apparent paradox is that "in the case of territorial efficiency, the features that define it are typical factors of externality" (ibid., p. 34). The next step is therefore to determine what type of financial institute produces these externalities most, and to devise policies which incentivise business strategies to concur with territorial efficiency. It is obviously not the same thing to run a bank in a developed or backward territory, to work with systems of small-to-medium firms or with large national or international groups. Hence, reconciliation between the two different efficiencies differs according to the context. It is therefore necessary to consider the differences in this regard between local banks and national and international ones, which substantially means evaluating the difference between small and large banks. But it is just as important to

[16] The same applies to the relationship between national-level banks and development.

appraise the weight of the institutional and corporate nature of banks, as well as the background and composition of their boards of directors.

3. Local banks and local development

Whilst the empirical evidence points quite straightforwardly to the conclusion that the role and importance of banking vary according to the pattern and level of a territory's development, more controversial is the hypothesis that the growth rates of local economies increase significantly with the territorial structuring of the banking system and the degree of development of local banks – defined as banks of small size operating in a circumscribed territorial setting and run by local managements (see Ferri, 1997). This positive influence may operate not so much by increasing accumulation as by improving the allocation of credit (see Alessandrini, Papi e Zazzaro, 2003, p. 24) through the greater effectiveness and efficiency of screening, monitoring and enforcement. Rootedness in the territory and participation in the life of the community may off-set disadvantages of scale and generate the "relationships of various kinds, not necessarily economic, whereby each member acquires information about the others which an external operator cannot have, or can only have by sustaining substantial costs" (Angelini, Di Salvo e Ferri, 1997, p. 298). It thus may become easier to ascertain the debt class of debtors, verify the extent of their opportunistic behaviour, and ensure that debts are repaid by inflicting or inducing social sanctions[17]. These advantages may even be greater in the case of cooperative credit banks (consider for instance the greater efficiency of peer monitoring) and may be further strengthened by the possibility to regain economies of scale at the level of consortia and by the tax concessions granted to such banks (see Ferri, 1990).

Because the hypothesis of the greater impact of local banking systems on a territory's growth hinges on their ability to establish closer and more flexible relationships with small and medium-sized firms, and to monitor their profitability, a first aspect to verify is the specific importance of this source of finance. A firm's financial evolution depends on size, age, and informational transparency. We may thus deduce that small, young and informationally opaque firms are forced to rely mainly on internal financing, commercial credit, and angel finance[18]. Only increased size and proven

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[17] See Stiglitz, 1990, Hoff and Stiglitz, 1990, and Varian, 1990.

[18] "Perhaps the most important characteristics defining small business finance is informational opacity. … small firms do not enter into contracts that are publicly visible or widely reported … do not issue traded securities … do not have audited financial statements that can be shared with any provider of outside finance. As a result, small firms often cannot credibly convey their quality … may have difficulty building reputations to

matches among balance sheet, orders portfolio and economic solidity give access to financial intermediation through private equity, venture capital, or indebtedness with banks and financial companies, and thereafter, in the case of the largest firms, access to public equity and the debt market. This evolutionary process seems to be confirmed by research. Berger and Udell (1998) report that the main financial sources (around 70% of total financing) for small firms are the principal owner, commercial banks, and commercial credit: this percentage diminishes, but not greatly, with the size and age growth of the firm. If, despite informational opacity, young firms are able to achieve a balance between internal and external financing, this is due to the fact that a significant proportion of external financing is in reality of internal origin because it is guaranteed by personal assets, mainly those of the owners – which highlights the financial interweaving between entrepreneurs and their firms[19]. A small firm's debt composition also depends on the sector in which it operates, with a greater likelihood of external equity investments (angel finance and venture capital) in sectors with high growth potential but also with high risk, and of external indebtedness with banks and other financial institutes in sectors with stable returns (ibid. p. 622-24, 619 and 626)[20].

A second aspect to consider is that the contribution by local banks to the growth of local economies considerably decreases when, instead of intermediating funds between savers and borrowers, they do no more than allocate credit deriving from and/or guaranteed by the government or other public bodies, as in the case of credit/finance support for targeted groups and/or areas. Adherence to these schemes – which have scant flexibility because they are based on highly standardized loan arrangements – may be a prudent strategy for the bank because they enable losses to be socialized to some extent. But it is not a particularly successful strategy, because the incentives for the effective control and selection of credit, as well as for its better collection, diminish. In these cases only a rigorous institutional project can prevent banks from "transforming themselves into inefficient instruments for the transfer of facilitated credit (at rates below market ones) to targeted groups, with poor results" (De Gregorio, 1997, p. 80).

However, even when local banks undertake normal credit intermediation activity, their greater capacity does not necessarily concretize in an

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signal high quality or nonexploitive behavior to overcome informational opacity" (Berger and Udell, 1998, p. 616).

19 According to Berger and Udell, 1998, p. 638, "91.94% of all small business debt to financial institutions is secured, backed by collateral; 51.63% is guaranteed by the owners of the firm".

20 The diversity of funding among similar firms may also be due to the fact that "different sources of funding may be substitutes or complements. … angel finance and venture capital are often complementary sources. … venture capital and public equity are also complements" (ibid., p. 627).

allocation of credit best suited to the territory's development. The duration and intensity of the credit relationship may foster phenomena which undermine allocative efficiency. An example is provided by situations of *ex post* information monopoly (bank capture). Firms with larger concentrations of credit with a bank have less financial leverage because, as the concentration increases and the cost of the investment necessary to assess the firm's creditworthiness grows, the bank acquires greater bargaining power, which enables it to impose more onerous conditions on rates and services and to appropriate part of the firm's profits (see Sharpe 1990 and Rajan 1992). For firms, this may neutralize their potential advantages accruing from the easier solution of information problems made possible by enduring client relations, inducing them to reduce the bank's informational control by resorting to multiple lines of credit and/or relying on short-term loans to manage their long-term financing. These reactions inevitably consolidate the insurance approach by banks at once not desirous and unable to direct and control firms already loath to subject themselves to their scrutiny, and they penalize the financing of new and smaller-scale business initiatives with greater information asymmetry problems[21].

Moreover, continuous and exclusive client relations may foster collusion between bank officials and local vested interests which large banks normally seek to prevent by rotating personnel. Or they may induce local banks to adopt conservative low-risk strategies which prioritize exclusive financial relationships with known firms undertaking activities already present in the area, to the disadvantage of new business initiatives and new production lines. This is because the habitual practice of examining the openings of credit in a given area may have reduced the ability to analyse and react to novelties, and because the success of new innovative firms may cause difficulties for those already operating, and in old sectors, threatening their solvency. Inevitably, this banking sclerosis also negatively affects the stimuli to innovate for already-operating local firms and thus impoverishes the territory's competitive potential (see Alessandrini e Zazzaro, 2001, p. 88, and Alessandrini, Papi e Zazzaro, 2003, p. 13).

Finally, the territorial rootedness of a local banking system may influence a territory's development through the intensity with which it helps propagate possible exogenous economic shocks (regional credit channel) or intensifies endogenous crises. This depends not only on the informational segmentation of local credit markets but also on the geographical segmentation of banking systems. The business efficiency of banks induces them to react to a shock, exogenous or endogenous, by adopting more restrictive credit policies

[21] "The insurance approach is desirable for banks because it divides not only information about the firms but also the relative financing, and therefore possible losses, among a multiplicity of uncoordinated banks. This approach also presupposes ample recourse to loan guarantees" (Ferri, 1997, pp. 21-22).

which safeguard their financial positions, thereby amplifying and prolonging the effects of the initial shock and decreasing territorial efficiency. The multiplier effect will be greater where the credit market is more closed and banks are less geographically diversified, because the impact of local economic conditions on their balances is stronger, and the difficulties encountered by firms in accessing external credit markets restrict the ability of the local banking system to grant them credit. Banks operating in several geographical areas are instead better able to off-set difficulties in the crisis zones with the better results obtained in the other operational zones. This multiplier effect, however, may be partly dampened by the greatest propensity of local banks to financially sustain their clients if it is easier for them to internalize the future benefits of their financial support (see Beretta, Omiccioli e Torrini, 2000).

4. Non-local banks and local development

Research reveals not just the greater dependence on bank credit of small firms, but also the lesser commitment of large banks to the latter. There are various reasons why large banks tend to neglect smaller firms: greater portfolio diversification, which makes it more costly for them to select and control smaller clients; organizational diseconomies, which may induce them to forgo certain market segments; the standardization of local-level client relations adopted to remedy information and agency problems; the centralizing to company headquarters of final decisions; prudential behaviour by often transitory branch managements (see Alessandrini, Papi e Zazzaro, 2003). Their relationships with smaller firms consequently tend to privilege high-quality credit, which can be evaluated with the same financial analysis procedures as used with large firms, and this helps explain why they can apply significantly lower prices in these cases (see Berger and Udell, 1998, p. 658).

Nevertheless, assessment of a local financial system's influence on the development of a territory must necessarily examine the role of national and international credit institutes and their different behaviours and strategies. Inasmuch as the evolution and efficiency of a local credit market is reflected in those of the productive system with which it works with a sufficiently precise geographical overlap, its behaviour and performance also reflect the territorial structuring of the banking system: where there predominate branches of external banks, corporate policy will centre mainly on considerations of size, economies of scale and variety, and diversification; where small autonomous banks predominate, policy will mostly centre on considerations of continuity and rootedness in the territory. Moreover, the relationship between bank and firm is influenced not only by the incidence of size and the similarities in the cost of banking and on the selection of local clients, but also by the firm's period of life. In periods of calm, "local banks can deal with the competitive impact of the larger banks by exploiting all their advantages of rootedness, continuity and customer loyalty". At extraordinary times (of start-up, crisis, quality and/or size change), the larger banks have "a clear competitive advantage which may counterbalance their lack of information about the local situation" (see Alessandrini e Zazzaro, 2001, p. 84)[22]. Entry into a territory by large banks, "in whatever form this comes about, whether on prices, on quantities, or on ways to undertake bank/firm relations", therefore also impacts "on the allocation of credit (and of real resources) among firms and production systems" (Alessandrini, Papi e Zazzaro, 2003, p. 11).

In this context, bank mergers and takeovers may have marked repercussions on the development of a territory if they significantly modify the characteristics of its local financial system. The consequences will be negative if rootedness and participation in the life of community is weakened and, above all, if lines of credit to efficient but small-sized firms, and to those in the start-up phase, are restricted[23]. They will be positive if they generate a better-quality and more abundant credit supply. That is: if local banks weak in terms of business and/or territorial efficiency are taken over; if the absorption into a bank of larger size preserves the autonomy and the experience of the local bank, allowing it at same time to grow quantitatively and qualitatively; and if the merger with other local banks is the result of an internal strengthening strategy[24]. In general, a local bank which consolidates and becomes more competitive can offer the "greater guarantees of local credit markets less conditioned by the extra-territorial strategy of the external banks, which in their turn will be induced to compete on specific local objectives" (Alessandrini, Papi e Zazzaro, 2003, p. 34.). On the other hand, entry into a local market by national and international banks may induce the already-existing smaller institutes "to create a niche market with local clients of smaller size, making it convenient to use 'housebank' facilities with the latter" (ibid., p. 10).

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[22] However, local banks can compensate for these limitations by improving their capacity to select firms and by activating forms of collaboration with specialized intermediaries and exploiting cultural and environmental affinities.

[23] "The reduction of loans to small firms would be a loss in terms of well-being for the community only to the extent that the firms to which the lines of credit have been discontinued had profitable investments" (Alessandrini, Papi e Zazzaro, 2003, pp. 19-20).

[24] It should be borne in mind that when "mergers and takeovers have involved two or more small banks, or when a small bank has been the incorporating bank, loans to small firms have tended to increase" (ibid., 2003, p. 19).

III. Local credit and territorial development in Italy

The financing of Italian small firms and their relationship with the local banking system are not easily referable to the two paradigms most customarily used: the British and American one, which substantially leaves the connection between saving and investment to the market; and the German and Japanese one, which is based on the presence of intermediaries. The available research and data show, in fact, that the collection of risk capital in Italy is based more frequently than elsewhere on personal or familial trust relations. Almost entirely absent are not only forms of firm control based on diffuse ownership, but also those exercised through forms of financial supervision by intermediaries. The reasons for this pattern should looked for in "the insufficient information available to the investor, a lack of corporate instruments giving an active role to the investor, the inadequacy of certain rules designed to protect minority shareholders, and the costs involved in stock market quotation" (Angeloni, Conti e Passacantando, 1997, p. 9). On the other hand, Italian local banks seem less able than elsewhere to support local clients, to overcome their suspicion of information control risks, and to evolve into the *Hausbank* form[25]. Symptomatic of this peculiar relationship between banks and local firms in Italy it is not only the greater frequency of multiple credit lines, but also the fact that even within industrial districts firms seemingly do not enjoy significantly better treatment by local banks, compared with those operating in non-district areas (see Signorini, 2000). Any client relations more favourable to small firms relate to the cooperative form of banks, rather than to their generic localism[26]. This chapter seeks to clarify the economic dynamics and policies that have favoured and consolidated this pattern, evaluating how it has interacted with Italy's patterns of development.

1. The background

1.1 The pre-war situation

From the normative point of view, the turning-point in the relationship between banks and firms in Italy was the 1936 banking law. Intended to stabilize the banking system, to restrict margins of hazard, and to furnish greater guarantees for savers, this law, however, reduced the efficiency of intermediaries. Three aspects in particular limited the influence of banks

[25] See Alessandrini e Zazzaro, 2001, Conti, 1997, Gigliobianco, 1997.
[26] See Angelini, Di Salvo e Ferri (1998), Ferri e Messori (2000).

over firms and conditioned future developments. Firstly, the separation among short-term, medium-term and long-term credit reduced the risks of intermediation but led to the segmentation and specialization of banking activity in operational and informational terms, thereby hampering unitary evaluation of the activities and financial positions of firms, and stimulating the mobility of clients and multiple lines of credit. Secondly, the prohibition on banks to acquire direct shareholdings in firms restricted the range of banking operations but obstructed possible synergies arising from the simultaneous management of credit, consultation and shareholding relationships. Thirdly, the Bank of Italy's tightening of supervision and control over banking activity gave greater stability to financial markets but inhibited competition.

It should be specified that the provisions of 1936 represented a break with the hitherto predominant mixed-bank model only for the few large national banks, which alone had relations with the big industrial enterprises. Those provisions only marginally affected the behaviour of the remaining smaller banks, which were largely extraneous to the model. This split in banking activity reflected the heterogeneity of the Italian production system, which at that time divided between, on the one hand, a liberal-protectionist capitalist economy characterized by industrial-financial concentrations and dependent on state-subsidized credit and support in times of crisis, and on the other, a peripheral economy dominated by fragmentation and short-run investments, by a lack of specialization, closure, and protection against competition by mass production. The provincial systems displayed very different levels of development, often marked by the marginality and backwardness in the country's South. Overall, technological innovation and long-term industrial investment were scarce, and so too was the propensity to increase the size of firms. The most common entrepreneurial strategy was to diversify activities and then abandon those which were no longer profitable (see Conti, 1997, p. 158).

The financial systems operating in the peripheral economy consisted mainly of small banks with simple organizational structures. Although the local credit market was profoundly changed between the two wars, both by the collapse of numerous smaller savings banks and by a more or less obligatory process of concentration[27], there was a still relatively dense system of competing banks and branches in the Centre-North. In the South,

[27] Until the First World War, the three or four large private ordinary credit banks and the galaxy of local banks more or less equally divided saving deposits between them. After the war, the strong increase in the number of banks created overbanking and potential instability. These were countered both with the 1926 law, which imposed a series of additional obligations and controls on banks and confined the institution of new banks within the limits of law, and by various forms of dissuasion and the encouragement of mergers. As a result, the 4000 banks operating in 1926 had diminished to fewer than 2000 on the eve of the Second World War.

by contrast, credit (above all outside the main urban centres) was often in the hands of unofficial operators, with easily imaginable consequences on the conditions. The strategy of these institutes – savings banks, people's banks, Catholic banks, and rural banks – was normally based on credit conservatism, with a preference for investment in government securities, activities guaranteed by local bodies, and loans to property-owners and affluent clients. Despite diffuse shareholding, the people's banks were generally managed by "presidents and board members from the local notability (nobles in decline, professionals, local personages with political ambitions, etc.), most of them property-owners but, it seems, with few links with industrial affairs", and with whom only some bank executives entertained close relations (Conti, 1997, p. 195). In this context predominated two behaviours which fuelled each other, and consequently attenuated the informational advantages deriving to banks from knowledge of the territory. Clients, even those operating on a small commercial or business scale, resorted to multiple credit lines. This enabled them "to put the banks in competition with each other … obtain credit in greater quantity, protect their independence and confidentiality, while increasing, in fact, their weak bargaining power *vis-à-vis* the same local banks" (ibid., 1997, pp. 169-170). In their turn, the banks, in order to reduce the costs of information and monitoring clients, preferred to involve second-order discounters in credit lines, such as property-owners and speculative business operators[28], privileging as solvency requirements commercial morality and, above all, financial solidity.

The character of the relationships between banks and peripheral firms prevailing in the pre-war period prompts Conti to doubt whether, in regard to financial aspects, the Italian model of diffuse industrialization originated in the decades preceding the Second World War. A bank's difficulty in acquiring the knowledge necessary to control the production process and the market situations of firms to be financed strongly restricted the formation of close relations between commercial and industrial interests and financial ones, and the possible realization of local models of the mixed bank. If anything, there was space only for "mercantile and speculative undertakings, which the banks … had little … inducement to enter." After all, the Bank of Italy itself, in order to counterbalance possible shocks deriving from the industrial and financial 'centre', was particularly vigilant, especially in the case of people's banks and cooperatives, to ensure that their relations with industry did not cross the limits of financing (Conti, 1997, pp. 190-3).

[28] This was a "complex system of principal-agent arrangements where information and responsibility proceeded in cascade from the bank to the final client, dispersing, via co-obligors, into a thousand rivulets" (Conti, 1997, p. 196).

1.2. The compromise between continuity and break-up and policies for the middle class

The war and the new democratic regime did not mark a true watershed in the Italian economy: the dilemma between continuity and break-up was resolved by reaching a compromise between very different ideas and interests, between attitudes and institutes inherited from the past and new models and productive orders, so that subsequent modernization was only partial and the bases were laid for contradictions which still today are being laboriously and belatedly addressed[29]. Great private capital was favoured both by the choice, partly obligatory, of international liberalism, and by the curbing of wages and workers' rights. In parallel, continuing the pattern set in the 1920s and 1930s, the so-called 'autonomous public bodies' (mainly state-controlled enterprises) were not only "confirmed and consolidated as means to mobilize and allocate savings but … employed as the central institution for the management of resources and for the strategic direction of economic development" (Barca, 1997b, p. 29).

Although this policy – concentrating the management of huge financial resources and the design of industrial development strategies into a few hands of proven experience – was efficacious for a certain period of time, it had two main shortcomings. Firstly, it relied excessively on the personal talents and sense of mission of the executives of the bodies themselves, taking continuity amid turnover for granted: an assumption resoundingly belied by the events of the following decades. Secondly, it privileged extraordinary intervention, while at the same time failing to do the following: design general planning policies; intervene in the ordinary workings of the economy, reforming the capital and goods markets,

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[29] It may be useful to summarize Barca's (1997b) fifty-year periodization:

1. **1945-62**: from Liberation to the onset of severe tensions in the labour market and the full political maturation of the centre-left:
   - 1.a. **1945-47**: reconstruction in partial continuity with the previous thirty-year period;
   - 1.b. **1948-58**: fruitful compromise among the different cultural and political components of society; the demise, especially in the mid-1950s, of opportunities to reform the rules of the political-institutional game;
   - 1.c. **1959-62**: following the first signs of crisis, a profound and enduring shift of the original model to a 'public neo-capitalism'.

II. **1963-68**: temporary resumption of high growth rates with increasing distortions in the allocation of resources.

III. **1969-76**: a long crisis, first mainly domestic, then also international, resolved by a new political change (governments of national solidarity), and the start-up of large-firm restructuring.

IV. **1977-92**: 'recovery without reforms': institutional immobility and inability to move beyond the logic of makeshift solutions; terminated with the economic and political crisis of 1992/93.

regulating the conflicts of interest inherent to them and re-establishing their selective function in the allocation of resources; reform the public administration, freeing it from the rigidities and privileges that impeded its efficiency[30]. The drawbacks and costs inherent in this compromise solution became evident in the late 1950s and early 1960s with the disappearance of the favourable conditions that had made it possible: the international economic situation, the submissiveness of workers, the quality and dedication of the public executives, non-interference by the party in power in the management and strategic choices of the 'autonomous public bodies'. However, also the new policies of the centre-left preferred compromise to taking up the challenge of reforming the markets and the public administration, so that there began a phase of planning without reforms and of public neo-capitalism (see Barca, 1997b, pp. 33 and 62).

One of the contradictions inherent in the compromise at the basis of the new regime should be stressed in particular. The decision not to implement active politics for industry and the other sectors, not to regulate markets, and not to reform the public administration, made it difficult to strengthen the productive middle class required by the new ruling class mistrustful not only of the ministerial bureaucracy (of pre-republican if not pre-fascist ancestry) but also of many sectors of large industry and finance[31]. In order to meet the economic needs of traders, artisans and farmers, under decisive pressure applied by their trade associations, the government set about constructing a complex preferential system for small businesses, especially industrial and agricultural ones. Established in the 1950s and developed in subsequent decades, this system consisted of an array of measures designed to compensate for the lack of institutional action by reducing costs. Ad hoc credit institutes, like *Artigiancassa*, extended the subsidized credit hitherto granted only to large firms[32]; funds were allocated and directly managed by special institutes connected to the public banks[33] and by specially-created

[30] The most serious attempt, unfortunately a failure, to undertake a long-period development programme conjugating private and public enterprise, the selective function of credit and modernization of the state, was the so-called 'Vanoni Plan' enacted in the summer of 1954.

[31] The already-existing dense network of acquaintance, consonance and solidarity among managers, *grands commis* and bankers, public and private, also cemented together by shared professional trajectories, was not affected by the mild purges of the post-war period (see Felisini, 2003). On the other hand, large industry was suspected of harbouring monopolistic ambitions: De Gasperi himself spoke of the "imperialistic ambitions of the capitalist plutocracy".

[32] The decrees granting subsidized credit to large firms were those of 1 November 1944 and 8 May 1946. Forms of subsidized credit for small firms acquired increasing weight after the 1964 recession and during the 1970s.

[33] The first provision on subsidized credit (L. 1419) was enacted in 1947 with the creation of a special credit section at the *Banca Nazionale del Lavoro* and recourse to the *Banco di Napoli* and the *Banco di Sicilia*.

regional bodies (among which the regional *Mediocredit* banks)[34]; a wide range of benefits and normative and fiscal exemptions were introduced, ranging among greater freedom to hire and fire, exemption from certain administrative and accounting obligations, partial exemption from compulsory social security contributions; and benign neglect in checks on non-compliance was adopted[35]. Although small firms were subject to more liberal regimes in almost all the European countries, only the Italian regime was so extensive, incisive, and accompanied by effective exemption from fiscal controls.

1.3. The transformation of local banks

Simultaneously with the economic consolidation of the middle class – or what some commentators have called its "artificial construction" (Banti, 1990) – a new role was devised for the smaller banks, the purpose being to involve them more closely in the financing of the peripheral economies. Although this was not "a well-defined and systematic programme, nor a strategy pursued with determination", the two processes "moved in unison along a development path founded upon the diffusion of the means of production among small agricultural, artisanal, commercial and industrial proprietors to form a society of diffuse capitalism without lacerating conflicts" (Conti e Ferri, 1997, pp. 436 and 435). The credit authorities thus had to reconcile two partially conflicting objectives: besides continuing to stabilize the banking system and to curb overbanking, a process which had begun in the 1920s, they had to foster industrial recovery and new entrepreneurship, guaranteeing efficacious credit assistance to all

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[34] Created or reformed between 1950 and 1953 were special regional institutes for the disbursement of subsidized credit to small southern firms (*Isveimer, Cis, Irfis*). The law instituting the regional *Mediocredito* banks (L.445) was enacted on 22 June 1950. Nevertheless, as shown by the slowness of their take-off and their limited results, various conditions hampered their affirmation, among them scant banks participation and the difficulties interposed by the supervisory authorities. As for the *Mediocredito Centrale* (the Central institute for medium-term credit to SMEs), founded to rediscount medium-term bank bills for institutes authorized to grant medium-term credit to SMEs, this was instituted by law no.949 enacted on 25 July 1952, and its statute was approved by Treasury ministerial decree on 12 December 1952; new powers were attributed to it by law no. 955 of 22 December 1953; finally, a ministerial decree of 26 April 1954 modified its statute.

[35] "The advantages of the special regime for small firms consisted of exemptions (for the artisan and his/her family members) from the higher costs incurred by the 'industrial' entrepreneur for social security and welfare, from the closer constraints and higher contributions connected with the employment of dependent labour, from higher fiscal pressure and the greater bureaucratic costs for fulfilments, and by a reduction in the cost of loan money. Moreover these advantages were extended to a progressively broader range of firms, and eligibility was made increasing definitive and certain" (Arrighetti e Seravalli, 1997, p. 361).

businesses, also smaller ones, within the constraints imposed by banking law.

Stabilization policies substantially continued the pre-war pattern throughout the 1950s. Not only did they encourage a new wave of bank mergers which only began to subside in 1947-48[36], but they pruned back the territorial ramifications of the former mixed banks in order to reduce their power and to prevent them from granting local credit to risky enterprises. The creation of new banks was blocked or greatly curtailed; so-called national-interest banks were effectively prevented from opening new branches in small towns, where by law credit assistance was to be furnished by public institutes or by the expansion of existing local banks (Gigliobianco, 1997, p. 206). "After the policy on branch openings was liberalized under Luigi Einaudi's governorship, the relative quotas for the number of branches and deposits collected among the various categories of credit institutions gradually stabilized until the 1970s, except for the relative growth of the branches of people's banks and saving banks and the deposit quotas of the latter, at the expense, especially after 1953, of policies to contain postal saving deposits (Conti e Ferri, 1997, p. 435). However, the reorganization of the smaller banks did not alter the difference between the banking system in north-western Italy, mainly oriented to the ordinary credit institutes, and that of north-eastern Italy, more favourable to the rural banks.

The main issue in development policies concerned the roles to be attributed to the national banks and the local ones. Both the governor Einaudi and his successor Menichella believed that priority should be given to the development of peripheral areas, which should therefore be endowed with a suitable supply of banking services. Best suited to this purpose, they maintained, were the small local banks, given the fear that the broader objectives of the larger banks might induce them to use the periphery more to raise deposits than to invest savings. Pursued after 1946, therefore, was a decentralization policy which, by relaxing the constraints of banking law, favoured the local banks, especially the savings banks, and enhanced their role (see Conti e Ferri, 1997, p. 444). This solution, however, gave rise to an ambiguous relationship between bank and firm, characterized by the strong dependence of the latter on the former, and by the absence of close relations between them, and which was therefore alien to both the German model of the *Hausbank* and to the British and American one of the pure commercial bank. "This ambiguity did not favour the banker's professionalism; nor could it furnish suitable financial support for the growth of the best entrepreneurship within Italian society" (Nardozzi, 2001, p. 43).

Banking decentralization was accompanied by a 'political conquest' of the savings banks which was accomplished mainly by altering the system of

[36] The total number of credit banks fell from 1378 in 1946 to 1257 in 1961.

cooption to administrative posts (De Cecco, 1968). The old local notability was gradually replaced by emergent social groups in a process made particularly delicate and complex by closer links with the political system and the magnitude of the interests involved in regard to the savings banks. Not always and everywhere did the new incomers represent the productive system and the industrial middle class. This was mainly due to the socio-economic features of the territories concerned. It may be said that the political conquest of the local credit institutes consecrated them as non-profit organizations in every sense: "nobody was interested in profitability and business efficiency, while the ambitions of board members and administrators were directed to the pursuit of other objectives, such as authoritativeness for the politicians, personal prestige for the professionals, control over the allocation of credit for the various representatives of industry and commerce: the exercise of control was not balanced by executive liability as in private companies. The co-option mechanism in the savings banks, which in the regions of Third Italy corresponded to the local banks, had become a 'Trojan horse' for the political control of credit, and above all for separation between liability and control in the medium-sized and small banks. The latter were thus the locus of the formation of entrenched oligarchies of local interests, with the recruitment of board members from the emergent industrial middle class, and influential actors tied to it through consultancies, positions of representation, and business relations of various kinds". Moreover, "'savings' institutes enjoyed increasingly broad margins of manoeuvre and acquired a relative monopoly in smaller areas, where they were often sheltered against competition. This enabled them to exercise covert but tenacious control over credit in their zones of influence" (Conti e Ferri, 1997, pp. 438-9 and 456).

The economic results of this broad restructuring of the local banking system were contradictory. On the positive side, the Italian peripheral economy did not in general suffer from a shortage of credit. However, this was not a sufficient condition for development: as shown by the geographical distribution of economic success, also necessary was the territorial efficiency of the investment selection system[37]. Restructuring had scant effects on the allocative efficiency of credit. Not only in the small banks, but in those of medium and large size as well, credit continued to be granted largely on the basis of personal guarantees, mainly property-based, so that little assessment was made of the applicant's future earning prospects: after

[37] Consider what happened in Southern Italy, where the ineffectiveness of the local banking system increased the cost of money. "More than running costs and higher business risks, the causes of this were banking regulations undifferentiated on a national scale and unable to induce competition in the sector. Consequently, the local banks, even if numerous, have little inclination to renew their operational practices and to exploit possible informational and positional advantages in regard to industrial and commercial clients" (Conti e Ferri, 1997, p. 458).

all, few banks were able to analyse a firm's profit and loss account[38]. This behaviour also prevailed in the mortgage and loans banks. Established to issue mortgages repaid out of future profits from the initiatives financed, these banks were further discouraged from investing resources in monitoring by the expansion of public facilitations in capital account and interest, and by the statutory requirement that loans must be approved by the public administration.

This situation induced broad recourse to self-financing, as well as to development credit camouflaged as commercial credit, with obvious negative repercussions on corporate investment decisions on a broad quantitative and qualitative scale, and therefore with long-period returns. This damaged above all those young and innovative firms of small-to-medium size which, because they could not offer sufficient guarantees on past results, had to wager on their prospects for growth and future profits to obtain finance. However, it should be pointed out that neither of the two groupings into which private industrialists divided seemed interested in the transformation of the financial system and its repercussions on business decisions. The innovators relied on their capacity for self-financing, and the conservatives on high market power, both of them confident that the virtuous investments-profits-investments circle would continue and that growth was assured (see Barca, 1997b, p. 19).

These conclusions are partially contradicted by the finding of Cosci and Mattesini, 1997, that the ordinary credit banks performed an important role in the organization of Italian industry in the first decades of the post-war period. "Those provinces with a higher level of intermediation in 1951 and in 1963, and a greater incidence of lending by the credit banks on value added, grew more quickly than others in the following period. … The gathering of information and the selection of investment projects by the credit institutes seemingly exerted a positive influence on the growth of investments and on the allocation of resources, thereby stimulating capital accumulation, technological innovation, and growth" (ibid., p. 124-5). However, this influence gradually dwindled away, as can be deduced from the correlations between banking activity and growth in the 1970s and 1980s. Also Cosci and Mattesini blame this on the growth of distortionary interference by the state in the credit market[39] and on the increasing weight

[38] In the 1950s, loans were generally small, granted in a ratio to assets of 1/10 or 1/20. What counted for the Bank of Italy inspectors was "the certainty that the credit would be returned sooner or later: sufficient to this end was that the firm's capital should be many times greater than the credit granted" (Gigliobianco, 1997, p. 217).

[39] "When state intervention in the credit market was relatively insignificant, as during the first post-war period, the banks performed a crucial role in driving development. … When the state assumed a more incisive role in the allocation of financial flows, and banks lost part of their autonomy in management decisions, as during the 1970s, the relation between

of the special credit institutes, which negatively influenced the growth rate[40].

2. The consequences

2.1. The strengths and weaknesses of policy for small firms

The provisions for small firms constituted less a coherent economic policy than an endeavour by the party in government[41] to gain consensus, as well as to compensate for harm caused to the system's efficiency by a lack of reforms and active policies for small firm sectors[42]. Nevertheless, according to Conti and Ferri (1997, p. 444), although these provisions "sometimes lacked an overall vision and were individually of limited scope, and in other cases had purposes other than real reform or the remedying of productive distortions and pockets of economic inefficiency, they slowly but steadily helped eliminate the credit discrimination afflicting small firms". Even more positive is the verdict passed by Arrighetti and Seravalli (1997, pp. 348-9), who maintain "that state action produced effects much superior to the simple preservation of a backward segment of the industrial structure; indeed, it substantially increased the efficiency of smaller firms, creating the bases for an initially weak component of the production system to act as a factor consolidating the economy as a whole".

These assessments are partially borne out by the sustained quantitative development achieved by SMEs until the early 1990s. In particular, when in the late 1970s and early 1980s large firms, first private and then public, began the costly restructuring process necessary to regain international competitiveness, the SMEs exploited the further strengthening of the preferential regime which they already enjoyed, and the opportunities

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financial structure and growth gradually diminished in importance" (Cosci e Mattesini, 1997, p. 126). Between 1963 and 1970, the volume of facilitated credit with respect to GDP (on which a state grant was paid, excluding land and agrarian credit) rose from 4% to 7% (from 7% to 14% in the South)".

40 "The ample flow of facilitated credit which the special credit institutes were obliged to grant by extraordinary intervention policies changed them, in certain respects, from financial intermediaries acting in accordance with market principles into bureaucratic organizations which restricted their activity to the mere disbursement of funds" (Cosci and Mattesini, 1997, p. 98).

41 "The middle classes feared that they would be fodder for the iron laws of the market. ... The DC [Christian Democrat party] turned itself into the mouthpiece of the provinces and the rural zones of the country" (see Conti e Ferri, 1997, p. 441).

42 "The transfers, facilitations and exemptions from normative obligations particularly favourable to artisanal firms were benefits unconditional on performance. They were extended to the entrepreneurial middle class in order to compensate both for the shortcomings of the financial system and the public services, and for the limited opportunities for growth due to scant competition on markets" (Barca, 1997b, p. 60).

created by the large firms' difficulties, to leverage their internal resources of enterprise and community, and their renewed entrepreneurial capacity. They thus achieved a surge in growth which, besides securing them broad profit margins, enabled the country to curb the economic and social costs of a difficult conjuncture.

On the other hand, these provisions were indubitably a compromise to evade active policies, which would have required greater courage and greater technical abilities, and replace them with extraordinary intervention. Opting for a system of exemptions and transfers accompanied by selective decentralized interventions, giving the public administration the merely formal task of vetting applications without monitoring the efficacy of interventions, disincentivating the banking system via the lesser risks of screening, gave normalcy to a normative and financial mechanism which in reality was anomalous. It may have been possible to justify these choices in the immediate post-war period, arguing that particularly delicate and unstable social and political equilibria would have been disrupted by a strategy to break with the past and profoundly restructure the economic system. But less comprehensible is why they were not only protracted, with nothing being done to make them temporary, but indeed intensified in the 1970s. And this to react to these difficulties – of origin first domestic and then international – which derived in large measure from, or were amplified by, failure to modernize the ordinary mechanisms of regulation represented by the market and the public administration. These contradictions, inherent in the initial compromise and not remedied by the 'recovery without reforms' of the 1976-92 period, became all the more evident when increasing international competition made it necessary to switch from a pattern of quantitative development to a qualitative one. Yet attempts to undertake the necessary reforms invariably encountered "insuperable difficulties once the country had learned how to operate with extraordinary instruments and had become addicted to them" (Barca, 1997b, p. 64).

2.2. Territorial differences and the allocative efficiency of investments

The prolonged success of the SME system can only be partly explained by the policies in its favour, since these also comprised aspects detrimental to its qualitative improvement. The policies worked very well when they interacted with other territorial factors: the positive results were in fact apparent mainly in the Centre-North, where networks of informal communitarian and familial relations, efficient local administrations, trade associations, and local banks integrated with the production system were able to perform the role of screening, selecting and monitoring investments neglected by policies. Where these conditions were lacking, the policies not only failed but often caused the system to degenerate.

Nor can the weight of territorial factors be neglected when evaluating the allocative function of local financial systems. The fact that these shared with debtors a communitarian network of strong trust relations suggests that they played a leading role in the decentralized development of the central-northern regions, especially in regard to new and/or small firms[43]. However, the results of the few empirical studies conducted on the matter are equivocal, and they raise questions which solicit further investigation. For instance, Cosci and Mattesini (1997) report a positive effect of financial intermediaries on the growth rates of the Italian provinces, especially in the organization of industry, but only so in the first decades of the post-war period. However, Lucchetti, Papi and Zazzaro (2001) have not found this effect at regional level, even if their research reveals a complex linkage between the banking system and income variation: particularly significant is the channel which connects lending in the region by banks and special credit institutes with the regional GDP and the efficiency of regional banking systems. A survey conducted at provincial level by Ferri and Mattesini (1997) yielded contradictory results: on the one hand, it confirmed the close relation between the presence of financial intermediaries and development until the 1970s; on the other, it recorded an inverse relation between the bank branches/total population ratio and future development. In the case of cooperative credit banks, however, the relation between the relative density of branches and the development of provinces was positive in the Centre-North, but it was so only after 1970: when, that is, the influence of the other local banks on development ceased because of the expansion of facilitated credit. In the *Mezzogiorno*, by contrast, still generally weak was the positive impact of cooperative credit on development, as well as the negative one of the relative density of bank branches[44].

Hence, whilst "thorough evaluation of the historical role of the local banks in industrialization 'without cleavages' still requires detailed analysis of the various situations and circumstances" (Conti e Ferri, 1997, p. 455), it is nevertheless likely that there is a cumulative causal mechanism – which recovers and adapts Joan Robinson's notion – whereby the development of the local credit system is not of exogenous origin alone, but also reflects the

[43] "This widespread endowment of local banks gave rise to a denser banking structure in the NEC [Centre-North-East] than in the rest of the country, and even in the more developed North-West. In its turn, the growth of the NEC was to the disadvantage of the larger banks more specialized in the rest of the country: between 1951 and 1981, the share of the BIN [national-interest banks] and the ICDP [publicly-owned credit institutes] of the deposits market fell from 42.7 to 31.2 percent" (Ferri, 1997, p. 25-26).

[44] The importance of location in determining access to credit has been highlighted by Finaldi, Russo and Rossi, 2000, who show that – size and performance remaining equal – firms in the South are subject to a higher cost of credit and tighter financial constraints.

growth of the territory's productive system and income[45]. In other words, whilst the initial development of the areas of small industrial firms were favoured by the pre-existence of certain features of the local financial systems[46], "the proliferation and expansion of the smaller local banks was due, *inter alia*, to deliberate action undertaken by nascent local entrepreneurial micro-forces intent on creating a primordial capital market able to mobilize the community's savings, thus to transform the already-existing structures and to start up new peripheral productive systems. Such action was supported, owing to a heterogenesis of goals, by the favour shown by economic policy, especially Christian Democratic, for small land and business ownership" (ibid., 1997, p. 430).

This positive effect of local entrepreneurialism on the allocative efficiency of credit could operate where the composition and behaviour of the boards of local banks reflected an orientation to profit. Where instead boards were mainly interested in redistribution – that is, the pursuit of rent – the peripheral banking system (which, moreover, was a crucial channel for the distribution of industrial policy incentives and the facilitation of credit) did no more than issue loans to predefined groups and/or with standardized criteria. This negatively influenced the selection of investments and the marginal productivity of capital, although not necessarily the bank's business efficiency[47]. This mechanism began to change in the 1970s as a result of the success itself of the peripheral economy, and when the large banks found it convenient to cater to the new centres of development now beginning to demand services which only they could supply[48]. Nevertheless, the underlying logic remained the same: the large banks were attracted to territories undergoing development – that is, ones with a leading class oriented to productive profit.

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[45] As said, the theoretical and empirical literature generally confirms the existence of significant links between finance and development, although it is difficult precisely to determine the direction of the causal connections.

[46] Until 1970, the peripheral banking system was characterized by a markedly smaller presence of large banks, such as the publicly-owned credit institutes (Icdp), and a slightly smaller presence of cooperative banks (people's banks and rural and artisan banks), compared with a much larger incidence of savings banks, ordinary credit banks (Boc), and, though to a negligible extent, the large former mixed banks, known at the time as national-interest banks (see Conti e Ferri, 1997, p. 448). Also to be considered are the local banks (more for their role as points of stable reference than for the magnitude of the flows intermediated) in local commercial credit circuits, often also informal, which rested upon compensation on balances of firm financiers within the same value chain (ibid., p. 454).

[47] On the relationship between the productive or redistributive orientations of the managing classes and economic development see Goglio, 1999 and 2004.

[48] In general, "the constraints on territorial expansion by banks, which were partially removed in the 1980s and eliminated at the beginning of the 1990s, favoured the constitution of local credit markets with relatively stable configurations over time" (Farabullini e Gobbi, 2000, p. 167).

2.3. The industrial districts

Analysis of circular causation between financial development and local development must necessarily concern itself with industrial districts, given their quantitative and qualitative importance[49]. As predictable, the present-day industrial districts have developed in areas already characterized prior to the Second World War by a greater density of local banking initiatives and branches, with a marked prevalence of small banks, but not micro ones (the so-called 'small giants') – mostly *Casse di Risparmio* and *Banche Popolari*, rarely *Casse Rurali e Artigiane* – with a local specialization broader than the district and extending into adjoining local systems (see Farabullini e Gobbi, 2000). More recently, the cooperative credit banks and people's banks have exhibited a greater tendency than other institutes to perform the role of local banks in industrial districts, as well as in non-district areas[50]. Overall, the financial level in districts is higher than in similar peripheral local systems (see Conti e Ferri, 1997), although Farabullini and Gobbi (2000) do not find this superiority in regard to those non-district areas located in the same geographical area as districts and sharing their demographic features.

The principal issue here is the generalizability of the hypothesis – long accepted despite a lack of detailed research – of a particular district banking localism constituted by small institutes embedded in the local community, closely integrated with the productive system and performing a privileged role[51]. This hypothesis not only implies that a local bank concentrates large part of its loans portfolio in the area, but also that firms in that area concentrate large part of their debts at the bank (see Baffigi, Pagnini e Quintiliani, 2000). However, a Bank of Italy survey on industrial districts conducted by Signorini (2000) does not confirm the existence of this twofold concentration. Establishing and maintaining a long-term relation between a bank and a enterprise is no easier than elsewhere, even for a local bank with a particularly large share of the district's credit market. The greater presence of local banks does not seem to generate particular forms of intermediation[52] or closer relations between district firms and local banks

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[49] If we compare the share of employment in the national total of specialized small firms operating in districts with that of small firms operating externally to districts, from 1951 to 1991, in the former case the figure increases from 4.2% to 15.9%, in the latter from 23.8% to 16.4% (Brusco e Paba, 1997, p. 302).

[50] The cooperative credit banks undertake this function in the smaller districts, but without providing significant support to the districts themselves (see Baffigi, Pagnini e Quintiliani, 2000)

[51] See e.g. Becattini, 1987.

[52] "Historically, credit intermediation has been no greater in districts than in local labour systems (SLL) with similar demographic characteristics, when indicators like the density of

which reduce "the 'normal' difficulty encountered by small and medium-sized firms in obtaining credit" (Pagano, 2000, p. 164). District firms do not have significant advantages on the cost and availability of credit; nor does it seem that banks perform an insurance function against interest rate increases. If anything, there is evidence of a closer dependence of district firms on internal sources of financing, and of greater credit rationing, probably because of the tighter financial constraints, compared with those of non-district firms, due to more cash flow-sensitive investments[53]. Also confirmed is the existence of a mechanism whereby the banking system transmits and amplifies the economic effects of a geographically localized shock (regional credit channel)[54].

The few studies conducted on banking localism in districts therefore tend to play down the role of credit structures in explaining the geographical differential in the economic development. The fact that the greater concentration of the banking supply in the districts is not accompanied by long-period banking relationships more important than elsewhere is indubitably due to two converging factors: on the one hand, the desire of firms (already amply discussed) not to depend excessively on one bank; on the other, the need of banks to diversify loans and risks. The territorial concentration of the loans portfolio in a strongly specialized area may in fact exacerbate the impact on the local financial system of idiosyncratic shocks, turning banking localism from an element of stabilization into a factor amplifying crises in the district economy, and neutralizing the possible advantages that the local bank may derive from district externalities (closer relations with firms, informational advantages, accurate selection of debtors, peer monitoring and extra-economic sanctions on insolvent

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bank branches and per capita bank loans are considered; and the supply of credit in districts has not been significantly more concentrated than elsewhere" (Pagano, 2000, pp. 161 and 162). See also Finaldi, Russo e Rossi, 2000.

53 The phenomenon has also been found by Pagnini (2000), who shows that districts record a higher incidence of overdrafts exceeding the amount granted: it is possible that interdependence among district firms generates specific transaction costs reflecting the cost and availability of external financing. These costs would be due to information asymmetry (it is not enough to know the firm; it is also necessary to know the entire district of which it is part) and to contractual incompleteness (district membership alters a firm's direct management, transfer or liquidation) (Baffigi, Pagnini e Quintiliani, 2000).

54 "When the local economy is hit by a crisis, banks react to the worsening of the financial position of their creditors and to the deterioration of their own balances by adopting more restrictive credit policies. This endogenous reaction tends to amplify and prolong the effects of the initial shock". The effects are tendentially more intense in provinces where the banking system is more closed: "the existence itself of a local credit channel seems to depend on the territorial segmentation of the banking markets. When the geographical diversification of banks is limited, the impact on their balances of local economic conditions is stronger. By contrast, banks operating in several territorial areas are better able to off-set their difficulties in the crisis zone with the better results obtained in their other operational zones" (Beretta, Omiccioli and Torrini, 2000, p. 283). See also Baffigi, Pagnini e Quintiliani, 2000 and Pagano, 2000.

debtors). These factors, besides small size and the increasing operational limits to the modernization of districts, may explain the tendency of local banks to reduce their functionality to districts over time, and to thin out their presence, unless they have particularly close relations with firms (Baffigi, Pagnini e Quintiliani, 2000).

However, as Farabullini and Gobbi (2000, p. 184) note, research findings fail to answer the question as to whether, from a historical perspective, "there is a causal nexus between the presence of these types of banks and the birth of districts, and if so, in which direction it operates". In other words, it is necessary to investigate whether the diffusion and intensity of relationships between banks and firms have been important for the birth and the initial development of districts, despite their subsequent attenuation. "Recent studies have … found that the structure of credit markets influences the birth rate of firms, and that the magnitude of the effect varies according to the degree of informational opacity and the capacity of the various sectors of economic activity to offer guarantees" (ibid., pp. 184-5). The widespread presence of banks of average and small size may therefore have had a maieutic role not dissimilar from that of venture capital, valid in general for developed territories, districts or otherwise, and distinguishing them from less-developed regions.

2.4. Cooperative credit

The hypothesis that the allocative and territorial efficiency of a financial system depends to a significant extent on its interaction with the local economy's pattern of development, and on the social context in which firms operate, seems also confirmed in the case of cooperative credit[55]. Since the 1970s, contemporaneously with the second wave of SME expansion, the cooperative credit banks have undergone notable growth in both their market shares and their support for small firms: whilst in 1961 they accounted for 1.2% of deposits and 0.8% of bank loans, by 1993 the amounts had risen to 6.9% and 4.5% (see Ferri e Di Salvo, 1994). Their activity is largely directed at their members: mainly households, artisans and farmers. They can thus achieve the minimum size efficient for these purposes, and by federating under a central consortium, compensate for their excessively small size[56]. Moreover, at least under the extant law, they can avert the danger of mergers taking place outside cooperative system. The share of credit lines extended to family-run and artisanal firms is above

[55] On the history and prospects of cooperative credit in Italy see Cafaro, 2000.

[56] Interesting in this regard is the model of the German cooperative banks whereby the individual bank, an autonomous entity, furnishes services, also international, produced by other intermediaries.

the average, while that allocated to financial enterprises is minimal: the average amount of credit is around half that of other banks. The observable characteristics of clients remaining equal, they have less risky portfolios, as shown by the default/loan ratio, and they make less frequent recourse to credit rationing, with particularly high use ratios even with overdrafts. "The performance of the cooperative credit banks, however, is geographically diversified. While the default/loan ratio for those in the North and Centre is less than that for the other banks in the same territorial area, the contrary is the case in the *Mezzogiorno*" (Cannari e Signorini, 1997, p. 379).

The competitive advantage of the cooperative credit banks seems to have augmented in most recent years, thanks to the exploitation of capacities which distinguish them from the ordinary banks. Besides enjoying fiscal and parafiscal privileges, they are rooted in the territory and have good knowledge of the latter. They are thus able to reduce information asymmetries, assess individual creditworthiness more efficiently,cut monitoring costs (also through peer monitoring), more closely constrain the borrower's behaviour after credit has been granted, and reduce adverse selection and moral hazard. Moreover, they have an intrinsic ethical dimension and a greater propensity for territorial efficiency resulting from their cooperative ethos. Nor should one neglect the likelihood of cooperative credit banks and their clients establishing some sort of implicit contract whereby the bank undertakes to stabilize the availability and the cost of money for businesses, while these undertake not to abandon the bank at times of abundant and cheap credit (see Ferri e Pittaluga, 1997) – although a survey by Angelini, Di Salvo and Ferri (1997) on the client relations of Italian cooperative banks does not confirm the above long-period hypothesis[57].

On the other hand, the small cooperative banks suffer, besides diseconomies of scale and scant international openness not always remediable through federation, various other drawbacks, such as conflicts of interest in favouring local operators and associates, and excessive reliance on informal practices due *inter alia* to the lesser mobility of personnel. Whether "these potential negative factors actually become disadvantages depends both on the organizational structure of each individual bank and on the characteristics of the environment in which it operates". Whilst in some areas and/or market segments the competitive advantages of the cooperative credit banks may prevail over those of other banks, elsewhere their disadvantages may do so. Specifically, the organization and ethos of the cooperative credit bank seem to yield the best results in those areas of the Centre-North where there predominate the local systems of small firms described by Becattini (1987) – which confirms that their characteristics

[57] Although it does confirm the peer monitoring hypothesis (see p. 298).

make them likely ‘candidates’ to alleviate the financial constraints on small and young firms. In territories characterized by different productive systems, the results will not be as good. In the case of the *Mezzogiorno*, moreover, not only do cooperative credit banks perform worse than other banks, but they tend to reinforce corporations and their rent positions (see Cannari e Signorini, 1997, pp. 376, 348-9 and 337).

IV. Conclusions

The role of a bank is to assure finance in situations where information asymmetries and incentivation problems obstruct a direct relationship between savers and firms. The financial circumstances of firms therefore differ according to the magnitude of information asymmetry and the need to prevent opportunistic behaviour. The financial theory of intermediation and practical experience suggest that small and medium-sized firms have financial exigencies different from those of large firms, and that banks may differ in their readiness to aid the development of small firms. One may therefore hypothesise a distinctive role for small banks, which, other conditions remaining equal, are better able to interpret the needs of nascent entrepreneurship and to place trust in it.

The weight of local banks in the ‘quantitative financing’ of small firms is quite well documented by research. However, “the evidence on the efficiency of local banks in selecting clients and on their ability to stimulate the growth of local economies is rather meagre” – or, at least, rather ambiguous (Alessandrini, Papi e Zazzaro, 2003, p. 21; see also Alessandrini e Zazzaro, 2001, pp. 85-6). In particular, the mechanisms that may facilitate the financing of small firms, and influence local development in general, seem to be more complex than those related to the role of local banks. They also comprise, besides the ways in which all the banks present on the territory operate, and the weight of commercial and personal credit, also the characteristics of the social and economic system as a whole and their impact on the financial system. Although the existence of a positive relationship between development of the banking system and local economic growth is undeniable, much work still remains to be done before the causal connections among, and the importance of, the various channels of credit are properly understood. This conclusion follows not only from the scarcity of empirical research but also from the differences among financial and productive, national and regional, systems.

These considerations are also borne out by Italy, where small banks have historically been most active in regions with systems of small and medium-sized firms. The banking network is denser in the Centre-North-East than in the rest of the country or in the North-West. People's banks and cooperative credit banks predominate in the Triveneto and Lombardy, while in the other regions of the Centre-North-East savings and private banks prevail (see Ferri, 1979). In Italy, however, the relationship between banks and small firms has developed in somewhat anomalous manner. Albeit with regional differences, small and medium-sized firms, especially in districts, exhibit a widespread under-capitalization counter-balanced by massive amounts of floating capital with unduly high debt coefficients. Short-term bank indebtedness to finance investments is very common, as are multiple lines of credit. Private capital is used indirectly to cover the increased risks for banks. Exacerbated by the limitations of political choices, the problems of information asymmetry and scant transparency have bred a reciprocal distrust between banks and small firms. This has weakened the basic conditions to stabilize and modernize the financial component of these firms: that is, to develop new instruments and processes of venture capital, intervention by funds, bond issues, the opening of share capital and, eventually, quotation on the stock exchange.

Escaping from this impasse requires the business system to overcome its resistance to interference in its operations, which also creates problems during generational change, and to pay closer attention to the firm's financial structure in order to drive down financing costs, even if this may have a certain impact on the ownership structure. The banks should strengthen their role as referents for firms, overcoming a fear of exposure not entirely justified by the difficulties of evaluating a closed and suspicious entrepreneurial world. They must be more courageous in acting as partners of firms, sharing risks and benefits with them, reducing risks in the sub-supply chain. They must switch from simple analysis of the financial structure to evaluation of the sector (or of the value chain) and relationships with clients and suppliers, and to dynamic evaluation of financial flows. They must be able to value local entrepreneurial initiatives, if they exist, so as to bring into being or expand a capital market which fosters the territory's development – that is, they must know how to mobilize local capital in the service of local entrepreneurship.

These problems have not been resolved by the great changes that have taken place in the Italian banking system in recent years, and which are still ongoing. If anything, they have been made more actual and urgent[58]. Whilst numerous local banking companies have grown, the larger banks are discovering the territory: the differences have therefore partly diminished. In the meantime, firms, even those of small size, have become increasingly

58 The same applies to the more intricate and ambiguous relationship between banks and large firms.

involved in international competition and have more sophisticated needs summed up in the concept of the direct banking: accurate knowledge of the territory and the needs of clients, flexibility and efficiency in the management of the relationship and in the supply of significant services, which now comprise international ones as well. Still unresolved, therefore, is the issue of whether there is a binding relationship between the size of banks and their capacity to furnish services to the systems of small firms, district or non-district. And the more general question arises as to the consequences of concentration in the credit sector on the relationship between firms and banks.

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